7500 SALES FACTOR

The numerator of the sales factor is the total sales in this state during the taxable year. The denominator is the total sales everywhere during the taxable year. (R&TC §25134.) Only sales derived from business activities are considered in the sales factor -- nonbusiness sales are excluded.

Historically, there were two schools of thought with respect to the sales factor. Since the property and payroll factors primarily reflected manufacturing or production activities, some authorities felt that a sales factor was needed to balance the other two factors and give weight to the market. Others thought that a sales factor was unnecessary and a two-factor formula of payroll and property was sufficient. The opponents to the sales factor cited the difficulty of assigning sales to a particular location or state. They argued that sales could arbitrarily be assigned to origin, destination, or even state of manufacture. The model formula under UDITPA uses an equally weighted three-factor apportionment formula that generally assigns sales to the state of destination, and this is the method that California used prior to 1993.

In recent years, many states have been using tax policy to create economic incentives. Accordingly, there has been a trend towards double-weighting the sales factor (this involves using a four-factor apportionment formula which includes the sale factor twice). By shifting the weight in the formula more heavily to the market states in which the taxpayer makes its sales, an incentive is provided for taxpayers to locate or expand in the taxing state. Double-weighting the sales factor generally reduces taxes for companies with headquarters or major production facilities within the state. Conversely, the tax burden is increased for those companies which exploit the markets in the state but who do not contribute to the state by creating jobs or paying property taxes. When other states began double-weighting the sales factor, California companies were disadvantaged because their taxes in those states were increasing. To promote investment within our state, California moved to a double weighted sales factor for taxable years beginning on or after January 1, 1993. There are still some exceptions to the general rule of double weighting the sales factor however, and these are covered in MATM 7005.

This section of the manual first discusses the general topics relating to the sales factor. Next, specific rules and audit techniques are discussed with respect to certain types of sales:

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7505 RECONCILIATION OF SALES FACTOR

If the entities included in the combined group are the same as those in the annual report or SEC 10-K, then those sources are an excellent tool for testing the sales factor denominator. If the reporting group is different, then the by-company detail in the workpapers to the financial statements can be used to piece together the sales for the combined group, although adjustments may have to be made to take into account consolidating adjustments for intercompany sales.

Although the Federal consolidated Form 1120 may be used to test the sales of domestic entities, it will not contain sales of foreign entities or of unitary affiliates that are owned less than 80%. When sales are compiled from separate Forms 1120 or from Forms 5471 (In*formation Return of U.S. Persons With Respect to Certain Foreign Corporations*), be aware of the fact that intercompany eliminations will not have been made. Although the Form 5471 contains a section for listing intercompany sales, it may not always be reliable.

By comparing the gross receipts from the financial statements to the denominator of the sales factor per Schedule R, you should be able to identify whether intercompany eliminations have been made, and whether the sales factor includes any types of sales other than trade receipts. Any significant differences between the financial statement sales and those reported in the sales factor should be flagged for examination.

If there are any unitary partnerships, remember that a share of the partnership receipts should be reflected in the reconciliation. The partnership receipts may be reconciled against the partnership financial statements or tax return. See MATM 7570 for further information regarding partnership sales.

While reconciling the sales factor, be alert for any unitary implications that may affect other areas of your examination. For example, substantial intercompany sales that are being eliminated for book purposes between the taxpayer and a nonunitary affiliate may be noticed during a reconciliation of sales from the consolidating workpapers. This should alert you to the possibility that a unitary relationship may exist between those companies.

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7510 DEFINITION OF SALES

The term "sales" is defined for apportionment purposes in R&TC §25120(e) as all gross receipts of the taxpayer not allocated under R&TC §25123 through R&TC §25127. In other words, sales are defined to include all gross receipts giving rise to business income. Gross receipts from nonbusiness activities are excluded. This definition expands the meaning of sales beyond merely trade revenues, and includes receipts from the sale of business assets, rental income, commissions, interest, and other types of receipts generated by the business. Receipts from nonrecognition transactions (i.e., like-kind exchanges, IRC §351 transfers, reorganizations, etc.) should generally not be considered in the sales factor. The treatment of various types of receipts in the factor is discussed in detail in the following sections.

CCR §25134(a)(2) places some parameters on the broad inclusion of all gross receipts in the factor by providing that receipts may be disregarded in some cases in order for the apportionment formula to operate fairly. Special rules for these exceptions are contained in CCR §25137(c), and provide for the exclusion of substantial receipts from incidental or occasional sales, insubstantial amounts from incidental or occasional activities, and income from intangible property for which no particular income-producing activity can be attributed. These exceptions are discussed in MATM 7512 -MATM 7516.

Intercompany sales are eliminated from the sales factor to avoid double-counting receipts. See MATM 7518.

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7512 Substantial Receipts

CCR §25137(c)(1)(A) provides:

"Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded."

On October 15, 1997, Legal Ruling 97-1 was issued. This Legal Ruling provides that if substantial amounts of gross receipts arise from an incidental or occasional sale of intangible property, held or used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. This is comparable to the treatment of substantial receipts from an incidental or occasional sale of fixed assets.

In the *Appeal of Fluor Corporation,* Cal. St. Bd. of Equal., December 12, 1995, the SBE held that if a sale satisfies the conditions stated in the above regulation (i.e., the gross receipts are *substantial*, and arise from an *incidental or occasional sale of a fixed asset*), then the regulation applies and no further showing of distortion is required in order to exclude the receipts from the sales factor. On the other hand, if either the taxpayer or the FTB objects to the exclusion of the receipts from the factor, then that party bears the burden of proof for establishing that application of the regulation does not fairly represent the extent of the taxpayer's activities in the state. The Fluor decision overrules the earlier decision in *Appeal of Triangle Publications*, *Inc*., Cal. St. Bd. of Equal., June 27, 1984, wherein the SBE had held that distortion must be proven before the regulation could be applied. For further discussion of CCR §25137 and deviations from the standard apportionment formula, see MATM 7701.

The presence of substantial gross receipts can usually be identified rather easily. The gain and loss schedule (Schedule D) will reveal large sales of business assets. Large dispositions of business assets are also usually disclosed in the annual reports, SEC 10-Ks and the notes to the financial statements. The reconciliation of the denominator of the sales factor (MATM 7505) will identify whether the taxpayer has included receipts other than trade revenues in the sales factor, and the taxpayer's apportionment workpapers will provide detail as to what items have been included in the factor.

Once substantial receipts have been identified, the nature of the taxpayer's business may give the auditor an indication of whether the receipts are from an incidental or occasional sale as contemplated by the regulation. For example, if a large retail grocery chain owns its own fleet of wholesale delivery trucks and replaces them pursuant to a regular replacement program, then the dispositions are a regular and routine part of the business activity and are not eligible for exclusion under CCR §25137(c)(1)(A) even if the amounts are substantial. On the other hand, suppose that the grocery chain decided to sharply cut back its trucking activities by making a large one-time reduction in its fleet. Since this would be an incidental or occasional transaction, it is the type of sale contemplated by the CCR §so long as it is "substantial" relative to the taxpayer's other activities.

It is important to remember that in order for CCR §25137(c)(1)(A) to apply, the receipt in question must not only be substantial, it must also be from an incidental or occasional sale. Not all receipts meet both criteria. For example, a disposition of business assets may qualify as an incidental or occasional transaction. However, the receipt may not be substantial. Alternatively, the taxpayer may have substantial receipts from a transaction, which do not meet the incidental or occasional transaction test. The receipt must meet both criteria before it can be excluded from the computation of the sales factor.

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7514 Insubstantial Receipts

CCR §25137(c)(1)(B) states that insubstantial gross receipts from incidental or occasional transactions or activities may be excluded from the factor so long as such exclusion does not materially affect the amount of income apportioned to California. By way of example, the regulation states that gross receipts from the sale of office furniture, business automobiles, etc., may be included or excluded from the sales factor at the taxpayer's option if the receipts are insubstantial and are the result of incidental or occasional transactions. The purpose for this provision is to ease the compliance burden to taxpayers by not requiring them to keep track of minor miscellaneous receipts for sales factor purposes.

Note: The taxpayer should be consistent in its treatment of such receipts from year to year. However, the exclusion of insubstantial receipts from the sales factor is at the taxpayer's option. Auditors may not use CCR §25137(c)(1)(B) to remove receipts which the taxpayer has included in the sales factor.

The main issue with respect to insubstantial receipts is one of materiality. In order for the taxpayer to exclude receipts from the sales factor under this test, the inclusion of the receipts must not materially affect net income apportioned to this state. There are no bright line tests for determining materiality. Exclusion of incidental receipts of $50,000 to a taxpayer with trade revenues of $500,000 may be substantial and will probably require further analysis. That same $50,000 in incidental receipts to a taxpayer with trade revenues of $50,000,000 is certainly immaterial and should be left to the option of the taxpayer whether to include or exclude. Situations that are not as readily determinable as those described above will require auditor judgment. By calculating apportioned net income with and without the incidental receipts, the potential tax change can be determined. If the taxpayer has been consistent in its treatment of these gross receipts and the potential tax change is not material, the taxpayer's method should not be adjusted.

If the test check turns out to be material and the receipts are not excludable under any other provisions of the law and regulations, then they should be included in the computation of the sales factor.

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7516 Unassignable Income From Intangible Property

Receipts from transactions involving intangible property are assigned to the numerator of the sales factor if the income producing activity is in this state. Receipts from transactions involving intangible property are also assigned to the numerator of the sales factor if the income producing activity is both in and outside the state if the greater proportion of the income producing activity is performed in this state, based on costs of performance (see MATM 7560). Where business income from intangible property cannot be attributed to any particular income producing activity of the taxpayer, the receipts cannot be assigned to the numerator of any state. CCR §25137(c)(1)(C) provides that such unassignable income shall also be excluded from the denominator of the sales factor.

CCR §25136(b) defines the term "income producing activity" to mean the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business. Such activity does not include transactions and activities performed on behalf of a taxpayer, such as activities conducted by an independent contractor. However, income-producing activities would include activities performed by other members of the combined report as long as the activities are directly related to the generation of the income. Acts of agents would also be attributed to the principal in determining the location of the income producing activity. The regulation specifically states that the mere holding of intangible personal property is not, of itself, an income producing activity.

To illustrate the application of these provisions, CCR §25137(c)(1)(C) provides the following examples of income from intangibles:

dividends received on stock
royalties received on patents or copyrights
interest received on bonds, debentures or government securities

If such income results from the mere holding of the intangible asset (i.e., stock, patents or bonds) and there is no income producing activity, then the receipts are excluded from the factor.

If the taxpayer's receipts from intangible property are material to the factor, the auditor should determine whether an income producing activity exists for each item of income. This determination cannot usually be made based solely upon the type of income. For example, if the taxpayer earns interest and dividend income from investments of excess cash that are managed by an unrelated investment firm, no income producing activity is engaged in by the taxpayer with respect to that income. On the other hand, if the taxpayer maintains an investment department staffed by employees whose function is to manage the investments, then those employees are performing an income-producing activity traceable to their work location.

Material sales of stock should be excluded from the sales factor if the location of the income producing activity cannot be determined, or if it is a substantial, occasional sale to which Legal Ruling 97-1 applies.

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7518 Intercompany Receipts

Intercompany revenues between members of a combined reporting group are eliminated from the sales factor. This avoids duplication and prevents an opportunity for manipulation of the factor. If Corporation A sells goods to B at $90 and B resells the same goods to outsiders at $100, only the $100 is included in the sales factor; the $90 is eliminated as an intercompany sale. See MATM 5260 for additional discussion of intercompany transactions.

Neither the statute nor the regulations specifically provide for the elimination of intercompany revenues. However, in Chase Brass & Copper Co., Inc. v. Franchise Tax Board [(1977), 70 CA 3d 457, 138 CRptr 901], the California Court of Appeal affirmed FTB's exclusion of sales between members of the unitary group. The Court reasoned that since the intercompany sales do not result in apportionable net income, there is no reason to represent those sales in the sales factor.

Only intercompany revenues within the combined unitary business are eliminated. Sales from a unitary business activity to a nonbusiness activity would not be eliminated. Similarly, sales between two nonunitary divisions of a corporation would not be eliminated. In a water's-edge group, sales to a non-combined foreign entity or possessions corporation, which is a United States domestic entity that has made an election pursuant to Internal Revenues Code section 936, would not be eliminated even though the entities might be unitary. Also, in a water's-edge group that has partially included entities where intercompany sales are involved, the auditor must take into consideration the partial inclusion element when determining the appropriate amount of intercompany sales to be eliminated.

The following are some common types of intercompany revenues that are eliminated:

- Sales
- Dividends
- Services fees
- Rents
- Management fees
- Royalties
- Interest
- Administrative fees

The eliminating adjustments in the workpapers to the consolidated financial statements should identify intercompany items. The chart of accounts may also reveal accounts that are reserved for intercompany revenues.

Although some intercompany eliminations may be made on the federal return, intercompany revenue from "period expenses" may not be identified for federal tax purposes. Period expenses are items for which the seller/service provider recognizes income in the same period as the buyer/service recipient deducts a corresponding expense. An example of a period expense would be intercompany rents, which are generally reported as income by the lessor in the same period as the related lessee deducts the rent expense. Since the income and expense are a wash in the consolidated return, they are not eliminated for federal tax purposes.

While reviewing the consolidating workpapers for evidence of intercompany sales, the auditor should be alert for significant intercompany activity with affiliates that have not been included in the combined report. Such activity can be an indication of a unitary relationship.

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7520 ASSIGNMENT TO NUMERATOR – TANGIBLE PERSONAL PROPERTY

Sales of tangible personal property are assigned to California and included in the numerator if:

The product is delivered or shipped to a purchaser in this state and the taxpayer (or another member of the combined report) is taxable in this state (the destination rule); or
The product is shipped from an office, store, warehouse, factory, or other place of storage in this state and neither the taxpayer nor any other member of the combined report is taxable in the state where the goods are delivered or shipped (the throwback rule).

Thus, under #1 above, goods shipped to a California destination from any point of origin are California sales so long as a member of the combined report is taxable in this state. Under #2, goods shipped from California to another state will also be California sales if no member of the combined report is taxable in the other state. Only sales of tangible personal property are covered by these rules (MATM 7522). The rules do not apply to sales of real property, services, or intangibles. Also, there is an exception to these rules for sales made to the U.S. Government (MATM 7535).

Note: The rules described above are set forth in R&TC §25135. That section refers to whether the "taxpayer" is taxable within a state. The departments's position regarding whether the word "taxpayer" means just the selling entity or all members of the combined reporting group has changed over the years. This issue is explained in more detail below, and is also covered in MATM 7530.

The first step in assigning sales of tangible personal property to the numerator of the sales factor is to identify the state to which the property was delivered or shipped (MATM 7525). Once this has been identified, the next question is whether the corporation is taxable in that state. To answer this question, the auditor must determine whether the state has sufficient nexus to tax the seller. With respect to domestic sales, the auditor must further determine whether the taxpayer is immune to taxation within the state under the provisions of Public Law 86-272. For a discussion of what is necessary to establish nexus or loss of immunity under P.L. 86-272, see MATM 1100 – MATM 1240.

The determination of whether a corporation is immune from taxation in a state is made on an entity-by-entity basis. For apportionment factor purposes prior to 1999 however, sales may be assigned to a state if any member of the combined reporting group is taxable in that state. This can result in situations where the sales factor numerator will contain sales attributable to a member that is not taxable in this state (such sales are often termed "reverse Finnigan sales"). In such cases, a special formula is required to apportion the California income among the taxable members of the combined reporting group. For more information on this issue, see MATM 7530 (Throwback sales) and MATM 7905 (The "Finnigan" Computation).

If no member of the combined reporting group is taxable in the state to which goods are delivered or shipped, then the sales are assigned to the state *from* which the goods were shipped (MATM 7530).

Most taxpayers selling tangible personal property maintain sales records by destination since assignment on that basis is standard under UDITPA. Taxpayers also usually maintain sales by origin or from point of shipment. To ensure that these by-state records include all of the taxpayer's sales, the total for all states should be compared to the sales included in the denominator of the factor and any differences should be reconciled. In addition, the auditor should review the by-state sales records to verify that all sales on the list are assigned to a particular state. Sometimes, the by-state schedules contain amounts designated as "unassigned sales" or "sales to nontaxable states." If material amounts of sales are not specifically assigned, the auditor should determine whether any portion of those sales are attributable to California. Specific steps for auditing the various numerator issues are discussed in detail in the following sections.

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7522 Tangible Personal Property Defined

Tangible personal property is perceptible to the senses and is usually discernible from intangible personal property. For assets such as computer software however, the distinction between tangible and intangible property can become blurred. See MATM 7152 for a discussion of this issue.

Occasionally, taxpayers will argue that a transaction is something other than a sale of tangible personal property in order to avoid the rules found in R&TC §25135. The following cases illustrate the importance of gaining an understanding of the taxpayer's activities and how its sales are structured and reported.

In *Appeal of Babcock and Wilcox Co*., Cal. St. Bd. of Equal., January 11, 1978, the taxpayer fabricated subunits for large steam generating systems in another state, and assembled the systems at the purchaser's location in California. Completed systems might cover an area as large as a city block. In addition to the fabrication, performance of the contracts for completed systems required many service functions such as planning, drafting, engineering, installation and testing. The taxpayer's position was that since performance of the contract involved so many elements, the transaction must be something other than the sale of tangible personal property. Therefore, the taxpayer argued that the sale should be assigned to the other state where the greater proportion of the income-producing activities was performed. The SBE did not agree with the taxpayer, stating:

"It is hard to imagine any manufactured product which, to a greater or lesser degree, does not involve many elements such as planning, design and engineering in its production. Nevertheless, the existence of such fact does not prevent the finished product from being classified as tangible personal property."

By looking to statutes (including the California Civil Code and the Revenue and Taxation Code) and cases, the SBE confirmed that the property was correctly classified as tangible personal property assignable to California as the state to which it was delivered or shipped.

On the other hand, in *Appeal of Mark IV Metal Products, Inc*., Cal. St. Bd. of Equal., August 17, 1982, the California-based taxpayer attempted to use the destination rule to assign revenue outside of California. The taxpayer manufactured tables and chairs from metal. A principal customer was a Texas company, which shipped unfinished steel to the taxpayer in California for fabrication into seat parts. The finished parts were then shipped by common carrier back to the Texas company. The taxpayer never held title to the metal or the metal products. By taking the position that the transactions were sales of tangible personal property, the taxpayer sought to have the sales assigned to Texas, the state to which the property was delivered or shipped. The SBE disagreed, holding that the sales were sales of services, not sales of tangible personal property. Since sales of services are assigned to the state where the income producing activity was performed, the SBE concluded that the sales were includable in the numerator of the sales factor.

In *Appeal of Dart Container Corporation of California*, Cal. St. Bd. of Equal., July 30, 1992, the taxpayer attempted to treat a portion of the sales price of its products as royalties assignable to the state where the income producing activity was performed. Sales orders were submitted to the parent, who then purchased the products from its manufacturing subsidiary nearest the customer, and resold them to the customer. The selling subsidiary drop-shipped the product to the customer. The parent paid the subsidiary a percentage of the selling price (76.5% - 88%) and was liable for all expenses associated with the sale. The taxpayer characterized the amount of the sales price retained by the parent as reimbursement for the costs connected with the sale, and the remainder as a royalty payment from the subsidiary for the use of the parent's technology. The taxpayer attempted to assign the portion of the selling price, which represented the royalties to the state in which the technology was developed.

The SBE did not allow the taxpayer's treatment, finding that there was no separate sale of an intangible item. Since tangible personal property was sold for a single price, the entire amount of the sales price constituted gross receipts from the sale of tangible personal property subject to the destination rule.

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7525 Delivered Or Shipped Defined

As discussed in MATM 7520, R&TC §25135 provides that sales of tangible personal property are assigned to California if:

the *property is delivered or shipped* to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or
the property is shipped from an office, store, warehouse, factory or other place of storage within this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

In order to properly assign sales under R&TC §25135, the determination of where goods are considered to have been delivered or shipped is often a key issue.

In the past, the department's position with respect to this issue was stated in Legal Ruling 348 (dated 1/24/72). This position was challenged in *McDonnell Douglas v. Franchise Tax Board* (1994) 26 Cal.App.4th 1789. In its decision, the Court of Appeal declined to follow the rationale of Legal Ruling 348. FTB subsequently issued Legal Ruling 95-3 (dated 7/20/95) to announce that Legal Ruling 348 is withdrawn and that the department will follow the holding in *McDonnell Douglas*. Legal Ruling 95-3 also discusses how the *McDonnell Douglas* analysis will be applied in various situations.

In the McDonnell Douglas decision, the taxpayer manufactured aircraft at a facility in California. The taxpayer's customers took physical possession of the aircraft in California, and then flew the aircraft to the state or country where the aircraft was to be used. The taxpayer took the position that R&TC §25135(a) would assign sales to California only if there was a "purchaser . . . within this state." Since the aircraft was destined for use outside California, the taxpayer argued that the purchaser was not "within this state."

FTB argued that the statute should be read to include sales if the property was "delivered . . . to a purchaser within this state," regardless of the ultimate destination of the goods.

Pointing out that the objective of the sales factor is to recognize the contribution of the consumer states to the production of income, the Court held that the statute requires that there be a purchaser within this state, and that the purchaser is not "within this state" if the goods are destined for use outside this state.

Appeal of Mazda Motors of America (Central), Inc., Cal. St. Bd. of Equal., 11/29/94, was decided by the SBE shortly after the McDonnell Douglas decision. In *Mazda Motors*, the taxpayer imported vehicles and parts from Japan for sale in the United States. The vehicles and parts enter the U.S. through two ports of entry in California, and some vehicles are placed in storage facilities maintained by the taxpayer while awaiting further shipment to their ultimate destination. According to an agreement between the taxpayer and its Gulf coast distributor, vehicles are deemed delivered to the distributor at the port of entry at 5:00 p.m. of the first day on which customs clearance is obtained. Title and risk of loss pass to the distributor upon such delivery, and the distributor is responsible for all taxes arising after that time. The taxpayer stores, assembles, installs accessories, repairs and services vehicles at the port of entry pursuant to the distributors directions. The distributor would then direct the taxpayer where and to whom to ship the vehicles and the taxpayer would arrange for the transportation at the distributor's cost. The taxpayer charged the distributor for all of these services.

The taxpayer argued that since the distributor did not take possession and control of the vehicles in California, delivery did not occur in this state. The SBE disagreed, stating that the taxpayer's own contracts clearly specified that delivery to the distributor occurred in California. Although the distributor did not take physical control over the vehicles, it exercised sufficient control to manifest an ownership interest. Furthermore, the activities of the distributor in directing the taxpayer as to the type of accessories to install "are indicative of something much more substantive than mere temporary storage in California for purposes of further shipment elsewhere in the stream of interstate commerce." The SBE found that those activities distinguished this case from a *McDonnell Douglas*-type situation where the out-of-state purchaser merely picked up the goods in this state.

To reflect the holdings in these decisions, the department has taken the position that a purchaser's receipt of goods within California for the mere purpose of immediate transportation to another state is not adequate to meet the R&TC §25135 requirement of a purchaser "within" the state.

On the other hand, if goods are shipped to a physical location of a purchaser in California, or if a purchaser takes possession (or constructive possession through an agent or bailor) in this state for purposes such as warehousing, repackaging, adding accessories, etc., the property is "delivered . . . to a purchaser within the state, " and the sale is a California sale. Any subsequent transportation of the goods to another state will not affect the California assignment of the sale.

NOTE: Once the goods have been delivered to the purchaser, the purchaser will have records to support the ultimate destination of the goods, but the seller will generally not have access to such records. It will be difficult for both auditors and taxpayers to know whether a receipt by the purchaser is the ultimate destination or merely the first step in an interstate transportation of the goods. Therefore, it should be presumed that any goods taken into possession by the purchaser in California have been delivered or shipped to a purchaser within this state. This presumption may be rebutted if the taxpayer can demonstrate that the purchaser immediately transported the property to another state. The auditor should therefore be careful to consider the relevance and reliability of any evidence provided by the taxpayer to determine whether they have met their burden of proof.

Conversely, sales delivered to a purchaser outside this state but ultimately transported to a destination within this state are California sales so long as the seller is taxable in this state. Since the information needed to establish the ultimate destination of goods will generally be in the control of third parties, it will usually be difficult to identify and examine this issue. Auditors should be sure to weigh the materiality of the issue against the resources that may be needed to secure the necessary documentation.

In order to be consistent with both the *McDonnell Douglas* holding and the purpose behind R&TC §25135(b), "shipment" will be considered to have occurred if either (1) the purchaser transports property to another state immediately after taking delivery from the seller, (2) the seller transports property to its purchaser in another state, or (3) a common carrier is used to transport property to the purchaser. Where goods are shipped from California, but neither the taxpayer nor any other member of the combined report is taxable in the state of the purchaser, the sales will be "thrown back" to California under the provisions of R&TC §25135(b) (see MATM 7530).

CCR §25135 contains examples of when a sale is delivered or shipped to a purchaser within this state. The following examples illustrate the application of these rules is some additional situations:

Example 1
A seller manufactures machinery in California, and sells it to a purchaser who has a place of business in State A and State B. The purchaser picks up the machinery in California using its own trucks, and transports the machinery to its own place of business in State A.

The machinery is considered to be shipped to the purchaser in State A. If the seller is taxable in State A, the sale is a State A sale. If not, the sale is thrown back to California. This outcome will result whether or not the purchaser happens to have a place of business within California.

Example 2
Assume the same facts as in Example 1, but a few days after the machinery arrives at the purchaser's place of business in State A, the purchaser transports it to its place of business in State B.

Sales will generally be assigned to the first physical location of the purchaser. In this situation, the machinery is considered shipped to a purchaser in State A. The sale is considered terminated at that point, and the subsequent transportation to State B has no effect on the assignment of the sale. If the seller is taxable in State A, the sale is a State A sale. If not, the sale is thrown back to California.

Example 3
Assume the same facts as in Example 1, except that the purchaser does not transfer the machinery to its own place of business in State A. Instead, the purchaser transports the machinery to a common carrier in State A and arranges shipment to its place of business in State B.

The purchaser did not have possession in California or in State A for purposes other than in the process of shipment. The ultimate destination is therefore considered to be State B. If the seller is taxable in State B, the sale is a State B sale. If not, the sale is thrown back to California.

Example 4
Assume the same facts as in Example 1, except that the purchaser does not transfer the machinery to its own place of business in State A. Instead, the purchaser transports the machinery directly to its own customer in State C.

The purchaser did not have possession in California for purposes other than in the process of shipment. The purchaser's customer will be considered the "purchaser" for purposes of R&TC §25135(a). If the seller is taxable in State C, the sale is a State C sale. If not, the sale is thrown back to California.

Example 5
A seller manufactures machinery in California. While the machinery is still stored at a location maintained by the seller, the seller transfers title to the machinery to the purchaser. The seller adds accessories to the machinery at the direction of the purchaser, and then places the machinery with a common carrier for transportation to State C.

Because title to the machinery passed to the purchaser in this state, and the purchaser took constructive possession of the property in this state for purposes other than in the process of shipment (as evidenced by the fact that the purchaser directed the seller to install accessories), the purchaser is considered to be "within this state" at the time possession was constructively delivered to the purchaser. The sale is a California sale.

Example 6
Assume the same facts as in Example 1, except that the purchaser does not transfer the machinery to its own place of business in State A. Instead, the purchaser transports the machinery to a location owned by a third party in State B. Under a separate contract, the third party adds accessories and repackages the machinery at the direction of the purchaser's customer. The goods are then transported to the purchaser's customer in State C.

Because the purchaser's customer has constructive possession of the machinery in State B under the *Mazda* holding, and because the machinery was not delivered or shipped to the purchaser in any state, the purchaser's customer is considered the purchaser for purposes of R&TC §25135(a). If the seller is taxable in State B, the sale is a State B sale. If not, the sale is thrown back to California.

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7530 THROWBACK SALES

NOTE: On April 22, 1999 the SBE issued its decision in *Appeal of Huffy Corporation*. In this case the SBE reviewed their *Finnigan/Nutrasweet* interpretation of §25135 and concluded that its "pre-*Finnigan* decision in *Appeal of Joyce, Inc.* is the better law." The decisions deal with the term "taxpayer" for throwback sales purposes. The general rule for determining which state a sale of tangible personal property should be apportioned (the numerator assignment) is the state of destination. An exception to this rule is where the taxpayer shipping the goods is not taxable in the state of destination perhaps due to PL 86-272. The Joyce rule provides that you look to each separate entity to determine if that entity is taxable in the destination state. Therefore, under the Joyce rule, sales are thrown back to the state of origin if the selling corporation is not taxable in the destination state. The *Finnigan/Nutrasweet* decisions held that the unitary group is the taxpayer. Accordingly, under the Finnigan rule sales are not thrown back to the state of origination if any member of the unitary group is taxable in the destination state.

In *Huffy*, the SBE noted that both FTB and taxpayers have relied on the *Finnigan* decision for the past eight years and ruled that their holding for a renewed implementation for the Joyce rule should be applied prospectively from the date of their decision. Therefore, for taxable years beginning on or after April 22, 1999, the FTB and taxpayers will again use the Joyce rule. For taxable years beginning before April 22, 1999, Finnigan is the rule.

When the taxpayer ships goods from this state to a state where the taxpayer is not taxable, the sales are assigned to the California numerator under the provisions of §25135(b). This is termed the "throwback" rule. As discussed in MATM 1200 – MATM 1240, Public Law 86-272 precludes states from taxing businesses whose activities within the state do not exceed solicitation of sales. Under the destination rule that is normally used to assign sales, this restriction on a state's ability to tax would frequently result in sales being assigned to a destination state in which the taxpayer would be immune from taxation. To prevent this result, the throwback rule requires such sales to be "thrown back" to the numerator of the state from which the goods were shipped.

There are three aspects of this issue that the auditor must consider:

If a corporation is selling goods destined for California, and that corporation's activities within California exceed the P.L. 86-272 threshold (i.e., the corporation is a California taxpayer), then the auditor should verify that the corporation is not throwing-back California destination sales to the states from which they were shipped. The auditor should also verify that the selling corporation has an assigned California corporation number.

If a seller's activities within California do not exceed the P.L. 86-272 threshold, but any member of the combined report is a taxpayer in this state, then the California destination sales are not thrown back to the state from which they were shipped.

If a taxpayer is shipping goods from California, the auditor should verify that the taxpayer is taxable in the destination states.

Note regarding foreign commerce: For sales between the U.S. and a foreign country, the standard for determining whether a corporation is taxable is constitutional nexus, *not* P.L. 86-272. See MATM 1240 for more discussion.

Identification of throwback issues:

When examining the by-state records for property and payroll, the auditor should be on the lookout for states in which the taxpayer does not have significant amounts of property or payroll. A throwback issue may exist if the by-state sales records reveal that the taxpayer makes sales to these states. To aid in identifying throwback issues, it may be helpful to construct a workpaper schedule for each year similar to the following nexus chart:

Destination states for products with a CA shipping origin	Nexus Indicators:				
	Return filed	Inventory	Assets	Rented Property	Payroll
1.					
2.					
3.					
4.					
5.					

Positive nexus items for each listed state should be listed across the chart. Filed returns should only be listed if they indicate bona fide activity within the state (as opposed to mere qualifying returns reporting a minimum tax). If the chart indicates that nexus has been established by way of a filed return or by property or rented facilities within a state, that state may be eliminated as a throwback candidate. Sales to remaining states with no returns or property have throwback potential and should be examined further.

NOTE: The above chart must be prepared for the combined reporting group as a whole for tax years beginning before April 22, 1999 to reflect the Finnigan rule. Sales to a destination state will not be thrown back to the shipping state if *any member* of the combined group is taxable in the destination state in accordance with the SBE decisions in *Finnigan/Nutrasweet*.. After April 22, 1999, the chart must be prepared on a separate entity basis to reflect the Joyce rule. Sales are thrown back to the state of origin if the selling corporation is not taxable in the destination state in accordance with the SBE decision in Huffy.

In the *Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal., August 25, 1988 ("Finnigan I"), the SBE ruled that in the context of §25135(b)(2), the word "taxpayer" means all members of the combined reporting group. Therefore, the SBE held that when a member of a group conducting a unitary business in California shipped sales from California to another state, the throwback rule does not apply if *any* member of that combined reporting group is taxable in the destination state.

Example: CF Company is an interstate trucking company that operates and delivers in all states west of the Mississippi. It files a combined return with TM Company, a trailer manufacturer, whose operations are solely in California. TM sells trailers to CF and to other customers, and the two companies are unitary. TM ships trailers to a customer in Arizona.

Holding (1): For tax years beginning before April 22, 1999, even though TM does not have any operations outside of California, its sales to Arizona would not be thrown back to California because CF is taxable in Arizona. This is the Finnigan rule.

Holding (2): For tax years beginning on or after April 22, 1999, TM sales are thrown back to California because TM is not taxable in Arizona. This is the Joyce rule.

FTB filed a petition for rehearing from the decision in *Finnigan I*, and the SBE then issued its *Opinion on Petition for Rehearing* ("Finnigan II") on 1/24/90. In Finnigan II, the SBE agreed that its opinion in Finnigan I was "analytically and philosophically incompatible" with *Joyce*, and expressly overruled *Joyce.* The opinion also clarified that this was strictly an apportionment rule. Although sales made by an entity that is immune from taxation can be included in the sales factor of the combined reporting group, the entity itself cannot be taxed. When it is necessary to identify the tax liabilities of each taxpayer in the unitary group, the presence of "Finnigan sales" will require a modification to the normal intrastate apportionment rules. These calculations are described in MATM 7905.

The *Finnigan I and II* opinions had dealt with a situation where sales were shipped from California and were deemed to be assignable to the numerator of the destination state. A question remained as to whether the same result would apply to sales shipped from another state to a California destination ("reverse Finnigan sales"). The SBE confirmed that its decision in Finnigan I and II applied equally to reverse Finnigan sales in *Appeal of The Nutrasweet Company*, Cal. St. Bd. of Equal., October 29, 1992.

Note that the Finnigan rationale only applies to combined reporting group members. Therefore, the fact that a unitary foreign affiliate has nexus in a particular location is not considered in determining the throwback sales for a water's-edge taxpayer if the affiliate is excluded from the combined report because of the water's-edge election.

Audit steps for examining throwback issues:

Once potential throwback sales are identified, the auditor can question the taxpayer as to their proper classification and possibly the issue can be resolved without additional work. If the taxpayer maintains that they are taxable in the destination state-, the following steps -should be taken:

If a taxpayer has filed a return and/or paid taxes to another state because of an audit adjustment in that state, and that state has an income or franchise tax, it is usually presumptive evidence that the taxpayer is taxable in that state. If so, the auditor should ask the taxpayer to produce copies of the other state return or other state audit adjustment. If a taxpayer voluntarily files and pays a tax, or pays a minimal fee for qualification, organization or for the privilege or doing business in the state, but does not actually engage in business activity within the state sufficient to establish nexus, then the taxpayer is not taxable in the state (Regulation 25122(b)(1)). The taxpayer may take the position that sales into the destination state are immune from taxation as provided by PL 86-272 but still file a franchise tax return and pay the minimum tax for various business reasons such as contract enforcement and ability to use that state's courts. In such circumstances, the department will not treat the taxpayer as taxable in the destination state as the minimum tax was paid for regulatory purposes and has no relation to the business activity in the state.

The auditor should therefore scan the other state returns to gain additional assurance that taxability exists. Unless there is a material tax effect however, the auditor should not spend a great deal of time on the issue if tax returns have been filed or tax has been paid pursuant to the other state's audit adjustment.

However, if the potential tax effect of a throwback sale is material, the fact that the taxpayer has filed a return in the destination state may not resolve the issue. A taxpayer, may self-assess or agree with the other state's audit determination if the result in assigning the sale to the destination state results in a net reduction in tax. The definition of materiality for the purposes of throwback sales is a large difference in tax between the additional tax paid to the destination state and the California tax savings by not throwing the sale back to California. The auditor should discuss this issue with his/her supervisor.

The auditor may pursue factual development of the potential throwback sale issue, assuming the tax effect is material, even though the taxpayer has filed a return in the destination state or agreed with the other state's audit adjustment. Audit adjustments may be proposed if the taxpayer does not have nexus in the destination state or is exempt under PL 86-272.

If a taxpayer has not filed returns or paid taxes in the destination state for the year at issue, taxability in the destination state for the year in issue must be established by incontrovertible evidence that the taxpayer's activities within the state cause nexus under the U.S. Constitution and exceed the activities protected by P.L. 86-272. (A complete discussion of nexus requirements and P.L. 86-272 may be found in MATM 1100 – MATM 1240.)

The *Appeal of The Olga Company*, Cal. St. Bd. of Equal., June 27, 1984, stated in part:

"Appellant was asked to prove that it filed a return required by any of the foreign states and paid any tax imposed. In response, appellant admitted that it filed no returns in any of the taxing states and presented no reasonable explanation why it did not file any returns. Therefore, we must conclude that appellant is representing to those states that its activities within those states are merely solicitation and that it is immune from taxation by reason of Public Law 86.272. We believe that this weighs heavily against appellant and that, in order to prevail, appellant must clearly establish that its activities within the foreign states go beyond mere solicitation."

When the situation exists of a taxpayer not filing returns or paying taxes in the destination state for the year at issue, the taxpayer should be asked to complete Form FTB 4505 "*Declaration to Support Claim of Taxability in Other States of the United States."* A copy of the form is included at Exhibit G.

Since the Form FTB 4505 contains the taxpayer's declaration, it should be completed by the taxpayer, not the auditor. The declaration itself will not suffice for relief from throwback. Activity claimed in the declaration is still subject to audit verification. The completed declaration should be submitted as part of the completed audit report, and Corporation Audit will furnish a copy to the destination state. The purpose for this form is to provide accountability by ensuring that sales that may not be thrown back to California are brought to the attention of the destination state where the taxpayer is claiming taxability.

Once the Form FTB 4505 Declaration has been completed, the claimed activities should be reviewed to determine whether they are sufficient to establish taxability. If the materiality of the issue warrants it, the auditor should verify the existence of the claimed property or activities in the state. For example, if the taxpayer claims that inventory is stored in a public warehouse within the destination state, the auditor may want to request the inventory confirmation letters that would have been sent by the taxpayer's outside accountants during the annual audit.

If the taxpayer will not sign the Declaration, then the auditor should continue the factual development. Consistent with the SBE decision in *The Olga Company* and CCR §25122 the taxpayer has the burden to clearly show that they are taxable in the destination state. Sales will be thrown back to California if the taxpayer cannot meet this burden.

Reviewed: February 2005

7532 Double Throwback

CCR §25135(a)(7) provides a rule for situations where the taxpayer is not taxable in *either* the state of destination or the state of origin. This situation might occur if a taxpayer's salesman located in California directs an unaffiliated manufacturer in one state to ship merchandise directly to the taxpayer's customer in another state. For example, assume a California sales office of the taxpayer directs a manufacturer in Colorado to ship merchandise directly to taxpayer's customer in Arizona. If the taxpayer is taxable in Arizona, then the sale is assigned to that state under the destination rule. If the taxpayer is taxable in Colorado, but not Arizona, then the sale is assigned to Colorado as a throwback sale. If taxpayer is not taxable in either Colorado or Arizona, then the Regulation provides that the sale would be assigned to California. This is known as the "double throwback" rule.

Reviewed: December 2002

7535 SALES OF TANGIBLE PERSONAL PROPERTY TO THE U.S. GOVERNMENT

Sales to the U.S. Government are an exception to the normal destination rule for assigning sales of tangible personal property. Regardless of whether the taxpayer is taxable in the destination state, sales to the U.S. Government are assigned to the state *from* which the goods are shipped (R&TC §25135(b)). The reason for using origin rather than destination is because the government often gives coded destination instructions to vendors for security reasons, hence the destination of products is not always known. This treatment applies only to sales of *tangible personal property* to the *United States* Government. Sales to state and local governments or foreign governments are subject to the normal rules for assigning sales.

In order to qualify as sales to the U.S. Government, CCR §25135(b) provides that the payments must be made directly by the government to the seller pursuant to the terms of a contract. When the party to the government contract is a prime contractor, sales made by the taxpayer as a subcontractor to the prime contractor are not included in this category even though the government is the ultimate recipient and the work is subject to government approval.

A sale of tangible personal property to the U.S. government is assigned to California when shipment takes place from an office, store, warehouse, or other place of storage in this state. Some sales to the government involve work done on a product in stages in several states. For example, work on a missile may be started in Florida. The missile may then be moved to Arizona where more components are added. Finally, the missile is moved to California where it is completed. Sale and shipment of the finished missile to the government takes place in California. If the taxpayer performed the entire project, the sale is assigned to California in its entirety. On the other hand, if the government pays different contractors for the work completed in various states, only the incremental work done by the taxpayer is included in the factor. Examination of the government contracts, annual reports or 10-Ks, or direct questioning of the taxpayer may reveal if this issue exists. If so, the auditor should verify that the sales have been treated correctly in the factor.

Where sales to the government are a mixture of tangible personal property and other types of receipts, a breakdown between the types of revenue is necessary. For instance, assume that the contract price for a sale of computers to the U.S. Government includes a service contract, and the amounts of the service fees are specified in the contract. The portion of the sales price attributable to the computer sale is subject to the special rules for sales of tangible personal property to the government while the portion attributable to the service contract is assigned under normal rules for service revenue.

Audit verification:
Schedule R of the tax return has a line item for California government sales. Even if no sales are indicated on this line, the auditor may want to look deeper for government sales, particularly if the

taxpayer is in an industry, which commonly deals with the government (aerospace contractors, for example). When examining these types of taxpayers, it is a good idea to inquire about the presence of government sales during the initial interviews as part of the auditor's familiarization with the taxpayer. Additional sources for this information are annual reports and SEC Forms 10-K, which may disclose business segments involved in government contracts.

If government revenues exist, the auditor must determine the type of revenues involved. Sales of tangible personal property must be segregated from other types of sales so that the appropriate assignment rules may be applied. The taxpayer can generally provide this information. The auditor may wish to verify revenue by examining contracts with the government, sales reports or runs, and general ledger summaries.

Once the amount of sales of tangible personal property to the U.S. Government are known, then amount of the sales shipped from California must be determined. The taxpayer's sales runs or similar records will generally identify the origin of the sales. As discussed above, however, the auditor needs to be careful to consider whether the sales records properly treat sales where no shipment was made and sales where components were added on in various states.

Reviewed: December 2002

7540 TRADE RECEIPTS

CCR §25134(a)(1)(A) provides rules for inclusion of gross receipts from sales of goods or products held primarily for sale to customers in the ordinary course of the trade or business. The amount of such receipts includable in the sales factor is computed as follows:

Gross Sales
- Returns and allowances
+ All interest income, service charges, carrying charges or time-price differential charges incidental to such sales.
+ Federal & State excise taxes (including sales taxes and value added tax) if such taxes are passed on to the buyer or included as part of the selling price of the product.
= Amount includable in sales factor

Returns and Allowances:

"Returns" are goods that have been returned for credit, and "allowances" include shortages in shipping, breakage, spoilage, inferior quality, and similar situations. The sales reported on Line 1 of both the Federal Form 1120 and the California Form 100 are "gross sales less returns and allowances," and should correspond to the amounts reported in the sales factor. Note that cash discounts for prompt payment of invoices do not reduce the gross sales price for factor purposes.

Excise Taxes:

CCR §25134(a)(1)(A) states in part "federal and state excise taxes (including sales taxes) shall be included as part of such receipts if such receipts are passed on to the buyer or included as part of the selling price of the product." In regard to the value added tax (VAT) charged by many foreign countries, the issue of inclusion of the VAT in the sales factor rests on the definition of "federal and state" and the determination if the VAT is an excise tax.

R&TC Section 25120(f) defines state as "...any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof." State includes foreign countries for the purposes of formula apportionment.

The term "excise tax" is a broadly defined term and includes a tax on the sale of goods as well as taxes based on consumption. A value-added tax is a tax assessed on goods and services on the value added by each producing unit. The value-added tax is essentially a consumption tax. Most VAT models exempt export sales from VAT.

The value-added tax qualifies as a state excise tax and therefore meets the criteria of CCR §25134(a)(1)(A) for inclusion in the sales factor.

The gross amount of the VAT should be included in the sales factor as opposed to the net amount paid. The distinction between gross and net and the mechanism behind the VAT is important to understand in order to include the correct amount.

As explained above, the value added tax (VAT) is a tax on the goods and services based on the value added by each producing unit. That is, in general, VAT is levied on the sale of goods or services, and a deduction (or credit) is allowed for any VAT paid on purchased goods and/or services.

For example, assume Corporation Ltd. manufactures umbrellas in the UK. During the month of April, Corporation Ltd. purchased £10,000 of materials to make umbrellas and sold £25,000 worth of umbrellas. Also assume the VAT rate is 20%. Corporation Ltd. would have withheld £5000 worth of VAT on the sale of umbrellas. In addition, the seller of the materials would have withheld VAT of £2000 on Corporation Ltd. purchases. The VAT return of Corporation Ltd. would disclose VAT of £5000 on sales, VAT of £2000 on purchases and a net VAT payable of £3000 to the British government.

The accounting entries are:

	Dr.	Cr.
Purchases	10,000	
VAT Recoverable	2,000	
Accounts Payable		12,000
To record inventory purchase.		

	Dr.	Cr.
Accounts Receivable	30,000	
Sales		25,000
VAT Payable		5,000
To record sales.		

	Dr.	Cr.
VAT Payable	5,000	

VAT Recoverable	2,000
Cash	3,000
To record payment of VAT liability.	

CCR §25134(a)(1)(A) states in part: "Federal and state excise taxes (including sales tax) shall be included as part of such receipts if such taxes are passed on to the buyer or included as part of the selling price of the product." The department will treat the amount of VAT paid by the purchaser to the seller as the amount of excise tax passed on to the buyer and included in the sales factor. In the Corporation Ltd. example, VAT of £5000 would be included in the sales factor.

In some instances the VAT return may show a net refund due to the corporation as the VAT paid on purchases exceeds the VAT on sales as not all of the sales were subject to tax. In such situations, the net refund due will not be included in the sales factor. Of course, the actual VAT on sales will be included in the sales factor.

Most countries assess the VAT on all goods and services. CCR §25134(a)(1)(A) only includes excise tax in the sales factor for a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products. Accordingly, the VAT on services or use of intangibles should not be included in the sales factor. Auditor judgment needs to be used in deciding to pursue this issue. For example:

The taxpayer is in the business of selling tangible personal products. The taxpayer also offers a warranty contract for extended product servicing. The warranty contract is most likely incidental to the sale of the product. The VAT on the service component of the sale should not be pursued.

The taxpayer is an international firm providing a service such as management consultant. VAT should not be included in the sales factor based on the taxpayer's business description.

The taxpayer's subsidiary in the foreign country is in the business of selling a product and licensing others to manufacture other products. The foreign country assesses the VAT on the products and royalty income. The royalty income is material based on a review of the federal Form 5471. The auditor should determine or if necessary, estimate the amount of VAT on the royalties and exclude that portion of the VAT.

Possible Audit Steps for the VAT:

An understanding of information is basic to resolving this issue. Possible items to consider include:

How is the VAT accounted for in the books of original entry? Are separate accounts for receivables and payables kept in the books of original entry? What are the debits and credits concerning the VAT?

Obtain a copy of the VAT return.

Do the footnotes in the annual report provide the amount of VAT paid? If so, additional audit steps might not be necessary.

Does the management discussion of the year's activities in the annual report provide the amount of VAT paid?

The auditor also needs to have an understanding of the taxpayer's operations in the foreign country. If the taxpayer only exports to a foreign country and does not have a presence in that country, the law of the foreign country may provide that the purchaser pays the VAT directly to the government. If so, there will be no VAT for the seller to take into account. Additionally, the type of business the taxpayer engages in is important to ensure that the correct VAT rate is used since some countries have different VAT rates for different products.

Similar to all issues, auditor judgment should be exercised. For example:

The taxpayer filed a claim for six years to include the VAT in the sales factor. The taxpayer only has source information for the two most current years. The auditor is comfortable that the taxpayer's methodology is reasonable given the facts and circumstances. The auditor could accept the first four years amounts based on the audit of the last two years.

The auditor knows from interviewing employees of the taxpayer that their foreign country operations are limited to the resale of inventory purchased from its parent. Export sales are not an issue. The taxpayer has a copy of the VAT return for the most current period and no export sales are listed on the return. The foreign country operations are limited to the sale of tangible property so that the VAT on personal services or use of intangibles is not an issue. The taxpayer through the Federal Form 5471 identified the amount of gross sales and intercompany sales. Since intercompany sales are eliminated from the sales factor the VAT on intercompany sales should likewise not be included in the sales factor. In such facts and circumstances it would be reasonable to estimate the VAT based on gross sales less intercompany sales times the VAT rate.

The taxpayer wants to estimate the amount of the VAT based on gross receipts in the federal Form 5471 times the VAT rate. This would not be reasonable without a showing of how the taxpayer takes into account the VAT on purchases, export sales, intercompany sales, etc.

CCR §25106.5-10, formally CCR §25106.5-3 and CCR §25137-6, requires the FTB to consider the effort and expense required to obtain the necessary information. CCR §25106.5-10(e)(1) provides "In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the Franchise Tax Board shall accept reasonable approximations."

Note: In many instances the information needed to compute the amount of VAT to include in the sales factor is under the control of foreign entities. The auditor will have to address CCR §25106.5-10 and the "reasonable approximation" standard of the US Supreme Court decision in *Barclay Bank Plc. V. Franchise Tax Board*, docket No. 92-1384 and docket No. 92-1839, June 20, 1994, 114 S. Ct. 2268, 512 US 298 mod. January 1, 1995.

It is important to remember in the Barclays' litigation that the California Supreme Court remanded the case back to the Court of Appeals to address the issue of whether the administrative burden for a foreign parent complying with worldwide combined report violates either the nondiscrimination component of the dormant commerce clause or the due process clause. The US Supreme Court extensively quoted the Court of Appeals decision. The Court of Appeals decision (California Court of Appeal, Third Appellate district Affirmed, California Tax Reports, New Matters at 402-279, 402-529 and 402-530) must be read in conjunction with the US Supreme Court holding to fully understand the issue of reasonable approximations. The Court of Appeal looked at current CCR §25106.5-10(e)(1), formally CCR §25137-6, and stated "it is this mandatory consideration of the effort and expense against the backdrop of data developed from the regularly maintained documents that circumscribes the Board's discretion under CCR §25137-6 and provides a framework for meaningful judicial review if the Board arbitrarily exercises that discretion." The Court of Appeal went on to say "the board must consider the cost and effort of producing WWCR (worldwide combined report) information in deciding whether to accept reasonable approximations, and that consideration is to use regularly maintained or other readily accessible corporate documents as the cost guideline."

The US Supreme Court in Barclays' Bank Plc. reviewed the Court of Appeal's application of the regulation. The Court concluded that the state's application of the regulation did not violate the taxpayer's constitutional rights.

As with any audit issue, auditor judgment as to materiality of the issue versus the burden on both the auditor and the taxpayer to resolve must be used to determine the technical correctness and the extent of documentation needed to allow the VAT in the sales factor.

Note: Individual country VAT information can be obtained from the BNA-Foreign Income Series Portfolio.

In addition to the value-added tax, other foreign taxes may qualify as excise taxes. For certain types of products such as alcoholic beverages, tobacco products or tires, the excise taxes may be quite material.

Inquiries of the taxpayer will usually reveal whether excise taxes have been included in the sales factor. Taxpayers are merely collectors of sales and excise taxes, and are responsible for remitting those taxes to the federal or state taxing authorities. Therefore, they will maintain sales records indicating the amounts of taxes. Depending upon how the records are compiled however, as stated above, reconstructing the excise taxes includable in the factor may be time consuming and should only be pursued when material.

Audit verification:

The audit steps for reconciling trade revenues in the denominator of the factor to the audited financial statements and/or the Federal 1120s are described in MATM 7505. Initial procedures for using the taxpayer's by-state sales records to verify numerator amounts are covered in MATM 7520. The auditor should verify that the trade receipts included in the denominator of the sales factor tie to the trade receipts reflected in the by-state sales records. Any material differences revealed by these reconciliations should be investigated further.

A problem that is commonly encountered with respect to the sales factor is that the by-state sales runs used to prepare the numerator may not be reported on the same basis as the sources used for the denominator figures. For example, the by-state sales runs of some taxpayers are shown at gross rather than net of returns and allowances. Since the information necessary to correct the numerator is not always available in a by-state format, taxpayers (or auditors) faced with this problem may attempt to use estimates to convert numerator sales to the proper amount. This is usually accomplished by applying percentages of the variances ratably to each state. For example:

Total Gross Sales	1,100,000
Total Returns & Allowances	-100,000
Total Net Sales	**1,000,000**

Sales from By-State Records :	
California	500,000
Arizona	400,000
Oregon	200,000
Total	**1,100,000**

$$\frac{\text{Total net sales}}{\text{Total gross sales}} = \frac{1{,}000{,}000}{1{,}100{,}000} = 91\%$$

By-State Sales at Net:	
California ($500,000 x 91%)	455,000
Arizona ($400,000 x 91%)	363,000
Oregon ($200,000 x 91%)	182,000
Total	1,000,000

The auditor should review the taxpayer's calculation to ensure that the method of estimation is reasonable.

Reviewed: December 2002

7545 GROSS RECEIPTS FOR PERFORMANCE OF SERVICES

Gross receipts received by a taxpayer for the performance of personal services by its employees are includable in the sales factor. If the services were performed in California, the receipts would be assigned to this state. If the services are performed in more than one state, then the receipts from the services are usually assigned to this state based on the ratio that time spent performing such services in this state bears to total time spent in performing such services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation, which gave rise to the receipt. The determination of whether receipts from personal services should be assigned to the numerator of the sales factor is made separately for each item of income.

Income producing activities associated with service receipts are identified separately for each item of income, and would include the rendering of personal services by employees or the use of tangible and intangible property by the taxpayer in performing a service. Income producing activities must be engaged in directly by the taxpayer, and therefore do not include activities performed on *behalf* of a taxpayer, such as activities performed by independent contractors. However, income-producing activities would include activities performed by other members of the combined reporting group as long as the activities are directly related to the generation of the service income. Income producing activities of an agent on behalf of its principal would be considered an income producing activity of the principal.

CCR §25136(d)(2)(C) provides the following example to illustrate this assignment of receipts from services:

Example
The taxpayer, a public opinion survey corporation, conducted a poll by its employees in State X and in this state for a sum of $9,000. The project required 600 person hours to obtain the basic data and prepare the survey report. Two hundred of the 600 person hours were expended in this state. The receipts attributable to this state are $3,000.

200 person hours **over** 600 person hours	**X**	$9,000	=	$3,000

Note that gross receipts from personal services might not necessarily be assigned to the same state to which the corresponding payroll is assigned. In the above example, if the base of operations for the employees performing the public opinion surveys were in California, all of the payroll would be assigned to the payroll factor numerator even though the gross receipts are allocated amongst the states in which the services were performed. For information regarding the numerator of the payroll factor, see MATM 7370.

Some contracts may involve elements of both personal services and other types of activities. For example, although an architect performs a service by creating blueprints for a structure, the end product is the blueprints, a tangible item. The auditor should address this issue by examining the substance of the transaction: is the client paying for a service or purchasing the end product? If the end product is only incidental to the service being performed, then the fee should be treated as compensation for the performance of services. Similar rationale is used for determining whether printers sell property or perform services (MATM 7785). On the other hand, the *Appeal of Babcock and Wilcox Co*. (Cal. St. Bd. of Equal., January 11, 1978) dealt with a situation where a contract for the fabrication of a steam generating system did involve service elements, but the SBE held that the contract as a whole was a sale of property. This case is summarized in MATM 7522. Resolution of this issue will depend on the facts and circumstances of each case. Factors that the auditor should consider in making the determination include how the transaction is characterized in the contracts as well as in the taxpayer's representations to others (i.e., annual reports, 10-Ks, etc.), and the relative costs of the various elements of the contract.

In some situations, contracts can be broken down between receipts for services and receipts from property. For example, a contract for the sale of machinery may include a maintenance agreement for the servicing of the machine by the seller's employees. Where such a situation exists, the contract price should be severed between the payment for services and the payment for property. The auditor will be able to identify this issue by reviewing the contract evidencing the transaction in question.

Incidental personal service receipts, such as from a maintenance contract, are not always evident on the return. The income may appear as gross receipts in "other income," or may be netted with any applicable expenses. In other cases, the income may be buried as a reduction in cost of sales or "other deductions." The taxpayer's type of business may indicate the possibility of such income. For example, a computer manufacturer could very easily have this type of income while a tire manufacturer would not. If a taxpayer is likely to have material personal service income but a scan of the tax return does not reveal the existence of such income, the taxpayer should be questioned directly.

Reviewed: December 2002

7550 FSC / DISC SALES

FSCs:
A foreign sales corporation (FSC) is a corporation organized under the laws of a foreign country that meets certain requirements specified in IRC §922. For federal purposes, a portion of a FSC's foreign trade income may be exempted from federal income taxation. Since California does not conform to the federal FSC provisions, FSCs are treated the same as any other corporation for state purposes. A more detailed discussion of the FSC provisions can be found in MATM 5220.

There are two types of FSCs, commission FSCs and sales FSCs. Different sales factor issues exist depending upon the type of FSC.

Commission FSCs: Commission FSCs are those that perform services for the U.S. affiliates, or that sell goods for the affiliates on a commission basis. Since the service fees or commission income received from members of the combined report are intercompany receipts, they are eliminated from the sales factor. Consequently, commission FSCs will generally have no sales to include in the sales factor.

Sales FSCs: Sales FSCs purchase goods from the U.S. affiliates to sell abroad. The primary sales factor issues involving sales FSCs will be verifying the FSC receipts, ensuring that intercompany eliminations have been made, and determining whether any throwback issues exist.

FSC gross receipts are not all reported in one place on the 1120-FSC return. The following computation illustrates the general method for reconstructing total gross receipts from the 1120-FSC return, but since the line numbers and format of the form change slightly from year to year, care must be taken to adapt the following computation if necessary.

Total foreign trading gross receipts (1120-FSC, Sch. B, line 6a)	$ xxxx
Nonexempt foreign trade receipts (1120-FSC, Sch. F, line 4)	xxxx
Nonforeign trade receipts (1120-FSC, Sch. F, line 17)	xxxx
Less excess receipts from small FSCs (already included in total foreign trading gross receipts) (1120-FSC, Sch. F, line 7)	(xxxx)
Total FSC receipts from 1120-FSC return	$ xxxx

If the FSC is selling goods purchased from the U.S. affiliate, the sales will be included in the factor when the goods are sold by the FSC to unrelated parties. Therefore, the intercompany sales from the U.S. affiliate to the FSC should be eliminated from the factor. If the intercompany items are material, the reconciliation of the sales factor denominator (MATM 7505) should identify whether eliminations have been made. If an issue is identified, the first step should be to interview the taxpayer to gain an understanding of exactly what the FSC does, and what types of intercompany items will be present. The 1120-FSC return (or the workpapers supporting that return) can then generally be used to identify the intercompany items. This procedure is best performed in conjunction with the 1120-FSC reconciliation described in MATM 5220 so that the auditor has a clear understanding of what income is being reported.

Transactions involving FSCs are primarily paper transactions. Therefore, it is not uncommon for goods sold through a FSC to be shipped to the customer directly from an affiliate's warehouse in California. If no member of the combined reporting group has property, payroll or sales in the destination country, a throwback issue may exist. See MATM 7530 for a discussion of the throwback rules, and MATM 1240 for the rules regarding nexus in foreign jurisdictions.

DISCs

A Domestic International Sales Corporation (DISC) is a domestic corporation that meets certain requirements set forth in IRC §992, including the requirement that 95% or more of its gross receipts be "qualified export receipts." For federal purposes, DISCs are subject to favorable transfer pricing rules and partial deferral of income on foreign sales. California does not recognize the federal DISC provisions, and treats a DISC the same as any other corporation. A more detailed discussion of DISCs may be found in MATM 5220.

DISCs have been substantially phased out by FSCs, but they are still seen occasionally. DISCs and FSCs present identical sales factor issues with respect to intercompany eliminations and throwback potential.

Reviewed: December 2002

7555 GOVERNMENT FACILITIES / COST PLUS FIXED FEE CONTRACTS

Some taxpayers will manage a U.S. Government-owned facility for the benefit of the government. The output of the facility is sold to the government by the taxpayer. Under a typical arrangement, the taxpayer will be reimbursed for all costs of management plus a fee. Costs can include reimbursable salaries, wages, manufacturing and operating costs. In some cases, the fee will represent the entire profit from the management of the facility and sale of output to the government. In other cases, the fee may be nominal (such as $1) and the taxpayer's profit will be realized from the sale of goods or services to the government from the managed facility.

In any event, any reimbursement, fee, and sale of output by the taxpayer to the government is includable in the sales factor (CCR §25134(a)(1)(B)). Since the facility and the product or service sold to the government actually belongs to the government, inclusion of all revenues received for expense reimbursement and profit in the sales factor gives weight to the taxpayer's business activity of operating the facility.

The primary audit problem in this area is knowing whether a taxpayer is involved in managing a government facility. As a first step, the auditor can consult the Schedule R of the tax return to see if the taxpayer reports any revenue from government sales to California. If the taxpayer is a public company, annual reports and S.E.C. Forms 10-K will usually disclose any material contracts or business dealings with the government. Once the auditor determines that the taxpayer has a cost plus fixed fee arrangement, the next step is to verify that the revenues have been reported correctly in the sales factor. The taxpayer should be asked about their treatment of the revenues. The taxpayer's apportionment workpapers will probably also have some details of the revenue from such contracts. If the contract is not top secret, it should be examined to verify the amounts that were paid and what the payments were for. The taxpayer's sales journal or general ledger summaries may be examined to insure that the proper amount of revenue has been included.

If the contract includes sales of tangible personal property to the U.S. government, those sales will be assigned to the numerator of the sales factor in accordance with the rules discussed at MATM 7535. All other types of sales related to cost plus fixed fee contracts with the government will be sourced in accordance with the normal sales factor rules. In most cases, revenues associated with the management of a government-owned plant will be assigned to the state in which the plant is located.

For special property factor problems related to management of government-owned plants, see MATM 7138.

Reviewed: December 2002

7560 INCOME FROM INTANGIBLES

Gross receipts from intangible property are included in the sales factor. The primary issue with respect to income from intangibles in the sales factor involves the proper assignment of the income for numerator purposes. R&TC Section 25136 provides that gross receipts from transactions other than sales of tangible personal property are assigned to this state if:

the income producing activity which gave rise to the receipts is performed wholly within this state; or the income producing activity is performed within and outside the state, but the greater proportion of the income producing activity is performed in this state, based upon costs of performance.

CCR §25136(b) defines the term "income producing activity" to mean the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business. The sale, licensing or other use of intangible personal property would be considered an income producing activity. Activities performed on behalf of a taxpayer, such as by an independent contractor, are not considered income-producing activities. Income producing activities performed by an agent are attributable to the principal, and would be considered income-producing activities of the principal. In addition, the Regulation specifically states that the mere holding of intangible personal property is not, of itself, an income producing activity.

The first issue with respect to assigning income from intangibles involves the identification of the income producing activity, which gave rise to the income. In some instances, no income producing activity can be identified, or the item of business income cannot be attributed to any particular income producing activity of the taxpayer. Where receipts cannot be assigned to the sales factor numerator of any state, CCR §25137 provides that the receipts shall be excluded from both the numerator and the denominator of the sales factor. This adjustment is discussed in MATM 7516. Special problems with respect to various types of income from intangibles will be discussed in the following sections.

The examples in the Regulation indicate that where the income producing activities are performed in this state, the receipt is assigned to the numerator of the sales factor. Alternatively, where the income producing activity occurs both within and outside this state, the receipt is assigned to the location where the greater proportion of income producing activity occurs, based on costs of performance. Not all receipts generated in more than one state from a single contract require a cost of performance analysis. Often there are separate income-producing activities in each state for which specific payments are received. In such cases, it would not be necessary to determine the state in which the majority of the income-producing activity was performed. The receipt would be assigned to the state where the underlying income producing activity occurred.

The auditor should review the underlying contractual agreement to determine whether a cost of performance analysis is required. In the cases where this determination is necessary, the proportion of the income producing activity within the state is measured by costs of performance. CCR §25136(c) defines costs of performance as direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the taxpayer's trade or business. Only costs of performance that have a clearly identifiable beneficial and causal relationship to the income from the intangible should be considered in the analysis.

One of the issues in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*., Cal. St. Bd. of Equal., June 2, 1989, involved the numerator assignment of margin interest. Under margin account contracts, some of the taxpayer's customers would leave their securities on deposit with the taxpayer. The taxpayer would advance funds in connection with the customer's trading activity, and the customer would be charged interest on any such advances. The FTB auditor revised the sales factor numerator to include the portion of the margin interest attributable to California customers. The taxpayer argued that the margin interest should not be included in the numerator of the sales factor because the income-producing activities giving rise to the income occurred in New York.

The SBE disagreed with the taxpayer's position, stating that the recordkeeping and billing functions that occurred in New York were primarily ministerial functions. It was the local brokers' taking and placing orders directly from the California customers that created the debts upon which the interest was paid, and the brokers handled most other day-to-day transactions which affected the balance of the customer's margin accounts. The SBE determined that it was the rendering of personal services by the brokers that was the relevant income producing activity. The SBE concluded that the margin interest paid by California customers should be included in the California numerator.

When the relevant income producing activity is performed in more than one state, the general rule is that receipts from intangibles should be assigned to the state in which the greater proportion of the income producing activity is performed. This is an "all or nothing rule." The decision in the *Merrill Lynch* case supports the position that the income-producing activity and costs of performance must be determined on a transaction-by-transaction basis, rather than by aggregating the transactions. (If the test were applied to the aggregate margin interest, then all of the margin interest would have been assigned to the one state with the greatest costs of performance as measured by the brokers' services.)

Reviewed: December 2002

7562 Dividend Income

As discussed above in MATM 7560, income from intangibles is attributed to the state where the income producing activity (or greater proportion of the income producing activity) is performed. With respect to dividend income, the income producing activity is often difficult or impossible to identify with any certainty. Only income-producing activities that are directly engaged in by the taxpayer are considered (CCR §25136(b)), therefore the activities of the dividend payor are not relevant to this determination. Because the mere holding of stock is not an income producing activity, the dividend income should be excluded from the sales factor if the taxpayer does not engage in any other identifiable activity with respect to the stock (see MATM 7516). On the other hand, if the taxpayer has an active treasury department, which manages a stock portfolio, the treasury function activities may be considered to be income-producing activities with respect to dividend income arising from that portfolio.

The audit techniques for examining this area are similar to the techniques for examining interest income in the sales factor. These techniques are covered in MATM 7564.

Reviewed: December 2002

7564 Interest Income

Income from intangibles, including interest income, is attributed to the state where the income producing activity (or greater proportion of the income producing activity) is performed (MATM 7560). The key sales factor issue with respect to interest income is whether the income producing activity can be identified. In order to make this determination, the source of the interest needs to be identified, and the auditor needs to consider the taxpayer's facts and circumstances.

If the taxpayer has an active treasury department, which manages its working capital, the treasury function activities may be considered to be income-producing activities. Interest income generated by those activities would be assigned to the state where the greatest proportion of the treasury activities was performed (based on costs of performance -- i.e., the costs of performing the treasury activities).

Interest earned from investments that are managed by banks or investment firms is generally not included in the sales factor because the income producing activity is not performed directly by the taxpayer as required by CCR §25136(b). Similarly, interest from long-term investments in bonds, debentures, government securities, etc. may not be included in the factor if the instruments are merely held by the taxpayer. MATM 7516 contains a discussion of this issue.

Interest income may not only be generated from investments, but also in connection with accounts receivable, goods sold on installment plans, deferred payment arrangements, and other routine transactions. This type of interest income is generally traceable to a particular sale, and the underlying sale is considered to be the income-producing activity. See MATM 7560 for a discussion of the SBE's analysis of this issue in the context of margin interest.

The principal difficulty in this area is segregating includable from excludable interest. If the issue is material, the taxpayer should be asked to prepare a breakdown of its various types of interest income by activity, and identify the locations of those activities. Since the taxpayer's accounting system will generally segregate interest income by type or by source, the general ledger summaries can be used to verify the amount of interest from each source. The auditor may want to question the taxpayer's methodology for assigning interest income that is incidental to sales transactions (such as interest on accounts receivable) to ensure that the assignment corresponds to the assignment of the sales themselves. If the taxpayer claims to have employees whose activities generate interest income (i.e., an active treasury function), the auditor should verify the activities of those employees. This may be accomplished by examining the job descriptions of the employees, reviewing any policy or procedure manuals related to their duties, and by interviewing the employees.

Reviewed: December 2002

7566 Royalty Income

Royalty income is included in the sales factor if it is unitary business income. As with other types of revenues, the gross royalties includable in the factor are not reduced by related expenses such as depletion or amortization. There are basically three types of royalties:

Royalties from natural resources such as oil and gas;
Royalties from tangible personal property such as machinery; and
Royalties from intangible personal property such as patents, licenses, and copyrights.

Royalties from natural resources and tangible personal property are assigned to the locations where the property is extracted or utilized (§25136(d)(2)). These types of royalties do not usually present any particular problems for auditors.

With respect to royalties from intangible property however, there must be an identifiable income producing activity on the part of the taxpayer in order for the royalties to be includable in the sales factor (see MATM 7560). The mere holding of a patent or copyright is not considered to be an income producing activity. Ministerial acts, such as the recording of payments onto the books and records or depositing the checks, are also not considered to be relevant income producing activities. On the other hand, if a taxpayer licenses a number of patents to others and employs a staff to monitor and service the patents, then an income producing activity may exist.

If the income producing activity with respect to a single item of royalty income is performed in more than one state, then the income must be assigned to the state in which the greater costs of performance were incurred. Costs to consider in making this determination would be direct costs such as salaries, office costs, and other expenses incurred in direct connection with the servicing of the intangible property or the licensing agreement.

If royalty income is material, the auditor will need to determine the source of the royalty and the activities involved in producing the income. The taxpayer may be asked to prepare a schedule of each type of royalty income, including a detailed description of the nature and location of the related income producing activities. Information on these schedules may be verified through interviews with the taxpayer's employees and by review of job descriptions or licensing contracts. The taxpayer should also have income and expense information for each profit center or location that may be useful in determining where the greater proportion of the costs of performance was incurred.

Reviewed: December 2002

7570 PARTNERSHIP SALES

If a partnership's activities are unitary with the taxpayer's activities under established standards (disregarding the ownership requirement), then the taxpayer's share of the partnership's sales will be included in the sales factor (CCR §25137-1(f)).

The partnership's sales are determined in accordance with the normal rules as set forth in R&TC §25134 - R&TC §25136. Such sales, net of any intercompany eliminations, shall be included in the factor to the extent of the taxpayer's interest in the partnership.

Example
Corporation A has a 20% interest in unitary Partnership P. Corporation A has total sales of $20,000,000 and P has sales of $10,000,000. A's total sales for purposes of the sales factor is $22,000,000 ($20,000,000 plus 20% of $10,000,000).

CCR §25137-1(f)(3) provides special rules for eliminating intercompany sales between the taxpayer and the partnership. Although the rules are summarized here, that regulation contains numerous examples and should be consulted if significant intercompany sales exist.

Sales by the taxpayer to the partnership:

Sales by the taxpayer to the partnership are eliminated to the extent of the taxpayer's interest in the partnership.

Example Corporation A's interest in unitary Partnership P is 20%. Corporation A's sales were $20,000,000 for the year, $5,000,000 of which were made to P. Partnership P made sales of $10,000,000 during the same year, none of which were to Corporation A or to other partners. Corporation A's denominator is determined as follows:

Sales by Corporation A		20,000,000
Add:	A's interest in P's sales (10,000,000 x 20%)	2,000,000
Less	The intercompany portion of A's sales to P (5,000,000 x 20%)	(1,000,000)
	Sales included in A's denominator	21,000,000

(CCR §25137-1(f)(3)(C), Example 1.)

Sales by the partnership to the taxpayer:

Sales by the partnership to the taxpayer are eliminated, but only to the extent that they do not exceed the taxpayer's interest in all partnership sales to partners.

Example: Corporation A's interest in unitary Partnership P is 20%.
Sales for the year were as follows:

Corporation A:			20,000,000
Partnership P:	To Corp A		3,000,000
	To other partners		6,000,000
	To nonpartners		1,000,000
Sales by Corporation A			20,000,000
Add:	A's interest in P's sales to nonpartners (1,000,000 x 20%)		200,000
A's interest in P's sales to all partners	(9,000,000 x 20%)	1,800,000	
Less: Intercompany sales from P to A[1]		(1,800,000)	0
Denominator of A's sales factor			20,200,000

[1] The intercompany sales may only be eliminated to the extent that they do not exceed A's share of P sales to all partners, or $1,800,000. If A's share of P sales to all partners had exceeded $3,000,000, then A would have been able to eliminate all of its $3,000,000 sales from P.

Special rules for the apportionment of business income with respect to unitary partnerships engaged in long-term contracts are found in CCR §25137-1(h). As explained in MATM 7710, the completed contract rules have been substantially phased out due to changes in the laws concerning long-term contracts.

Each partner, whether general or limited, is considered for purposes of sourcing income to be conducting the trade or business activity of the partnership (see CCR §26137-1(a), (f), and (g). see also *Valentino v. Franchise Tax Board* (2000) 87 Cal. App. 4th 1284, applying the business activity attribution principles to an S Corporation shareholder). Therefore, if a partnership has activities in a state that exceed the P.L. 86-272 threshold (see MATM 1200 – MATM 1240), then the unitary corporate partner will be considered to be taxable in that state. Even if the corporate partner has no activities of its own in that state, sales to the state will not be thrown back.

A corporate general partner will be considered "doing business" in California if the partnership is "doing business" in the state. Accordingly, the corporate general partner is subject to the franchise tax. (However, if a corporation's only connection to California is as a limited partner in a partnership that is doing business within the state, then the corporate partner will not itself be considered to be "doing business" for purposes of the franchise tax. A partner in a limited partnership has no interest in specific partnership property. (Cal. Corp. Code, §15671.) Therefore, absent a unitary relationship with the partnership, the corporate partner will be taxable under the corporate income tax on its California source distributive income rather than the franchise tax. See *Appeal of Amman & Schmid Finanz AG, et. al.,* Cal. St. Bd. of Equal., April 11, 1996, also MATM 1310.) Note that under the income tax, interest income from California and federal obligations is excluded from income.

Examination of the items making up "Other Income" (line 10 of the Form 1120 return) will usually indicate whether the taxpayer owns partnership interests. The annual reports or SEC 10-Ks may also discuss significant partnership relationships. If the taxpayer has interests in unitary partnerships, the reconciliation of the sales factor to the annual reports or 1120s will normally disclose whether partnership sales have been included in the factor. The partnership returns (California Form 565, or Federal Form 1065) can be used to verify the total sales amounts. If audited financial statements have been prepared for the partnership, they will usually disclose any material intercompany transactions between the partners and the partnership.

Reviewed: December 2002

7575 OFFSHORE SALES

Offshore sales issues generally relate to oil and gas operations or ocean-going vessels. Discussion of this issue may be found in MATM 7795 (*Oil & Gas Industry*) or MATM 7760 (*Sea Transportation*).

Reviewed: December 2002

7580 RENTS

Gross rents incurred in the unitary business are included in the denominator of the sales factor. The rules for assigning rents to the numerator of the sales factor are described in CCR §25136. As the Regulation explains, the income producing activity, which generates the rents, is the actual rental or leasing of the property. Therefore, the gross rents are assigned to the state where the property is located.

If the property is used both within and outside this state during the rental period, the rental in each state is considered to be a separate income producing activity. Gross receipts attributable to California in such cases will be measured by the following formula:

		Days property was physically present or used in this state
Total Gross Rents	**X**	**Over**
		Total time or use of the property Everywhere

Rental income can usually be found on line 6 of the 1120 or Form 100. Occasionally, it may also be reported in the "other income" section of the return. Since this income is often reported net of any related expenses such as maintenance or depreciation, the auditor should verify that the sales factor reflects only gross amounts. The taxpayer will usually maintain records, which will identify the rental sources on a by-state basis, and these should be requested to verify the numerator. If necessary, the locations and amounts from the by-state records can usually be verified by the general ledger summaries and property ledgers. Rental income included in the sales factor should be net of intercompany payments.

Although it is more difficult to obtain information regarding the location of mobile property, taxpayers will generally keeps these records available because they are necessary for property tax purposes. If the materiality of the issue warrants reconstructing the location of mobile property during a rental period, the taxpayer should be asked to identify the types of documents, ledgers, job cards, etc., that they use to track this information.

Reviewed: December 2002

7585 SALE OF ASSETS

Generally, the gross sales price of assets used in the business is includable in the sales factor. Exceptions to this rule may be made to exclude substantial receipts from incidental or occasional sales, insubstantial receipts from incidental or occasional activities, and receipts from sales of intangibles for which no particular income-producing activity can be attributed. These exceptions are discussed in MATM 7512 – MATM 7516.

Taxpayers will often include net gains from asset sales in the factor rather than the gross receipts. If the sales price is substantially higher than the net gain, this can result in material adjustments. The Schedule D or Form 4797 may identify the sales price for the asset sales. If not, the auditor should request the supporting workpapers for those schedules. Unless the transaction meets one of the exceptions to inclusion in the sales factor computation, gross receipts from the sale of assets should be used in computing the sales factor.

Sales of tangible personal property are subject to the rules under R&TC §25135, and the numerator assignment of such sales is covered in detail in MATM 7520. Sales of real property are assigned to the state in which the real property is located (CCR §25136(d)(2)(A)).

Sales of intangible property are more difficult to assign to a particular state. If the income producing activity can be identified and attributed to a particular state, the sale will be assigned to that state. For example, if a taxpayer has a cash management department that buys and sells short-term securities on an ongoing basis, the gross receipts from those sales will be attributed to that location. If the income producing activity is both within and outside the state, then a cost of performance analysis may be required to determine whether the gross receipts are includable in the numerator of the factor. When the receipt from the sale of an intangible cannot be attributed to any particular income producing activity, then CCR §25137(c)(1)(C) provides that the sales must be excluded from the factor altogether. See MATM 7516 for further details regarding this issue.

Reviewed: December 2002

7587 Installment Sales

When a taxpayer reports sales under the installment method, gains are reported in periods subsequent to the year of sale. In contrast, because the apportionment factors are intended to reflect the activities that give rise to income, the entire gross receipts from installment sales are included in the sales factor in the year of sale. In the subsequent periods when the gains from the installment sales are recognized, those gains are apportioned using the factors from the year of sale (FTB Legal Ruling 413; upheld by the CA Court of Appeal in Tenneco West, Inc. v. Franchise Tax Board, (1991) 234 Cal.App.3d 1510).

Example
In Year 1, Corporation X sells an asset on an installment basis. The sales price was $1,000,000, and X recognized a gain of $500,000. The installment proceeds were received in two equal payments in Years 2 and 3.

X had an apportionment factor for Year 1 of 20%, which includes the entire $1,000,000 installment sale. No portion of the installment sale is reflected in the factors for Years 2 and 3, and the apportionment factor was 10% for each of those years.

X's income apportioned to California for Years 1, 2 and 3 will be computed as follows:

Year 1:					
Income other than installment sale:	$3,000,000	x	20%	=	$600,000
Installment gain:	0				0
Total apportioned to Calif.					$600,000
Year 2:					
Income other than installment sale:	$2,000,000	x	10%	=	$200,000
Installment gain:	250,000	x	20%	=	50,000
Total apportioned to Calif.					$250,000
Year 3:					
Income other than installment sale:	$4,000,000	x	10%	=	$400,000
Installment gain:	250,000	x	20%	=	50,000
Total apportioned to Calif.					$450,000

Legal Ruling 413 indicates that dealers who regularly sell tangible personal property on an installment basis are not required to apportion installment gains using year-of-sale factors if the factors do not vary significantly from year to year. Since dealers are not permitted to use the installment method in most circumstances after 1987, this exception will not arise very often.

Since the installment method is used only for tax purposes and not for book or financial accounting purposes, the presence of installment sales should be reflected on Schedule M-1. If a material installment sale is detected, the auditor should examine the taxpayer's apportionment workpapers to insure that the installment sale has been correctly reported in accordance with Legal Ruling 413.

Reviewed: September 2003